more give, less take

Bulk Commodities Update

by NAB Group Economics

October 2014

National Australia Bank

Key Points:

- China's third quarter National Accounts showed the economy grew by its slowest rate since March 2009. From a bulk commodity perspective, key parts of China's economy remain comparatively weak. Industrial production has slowed in recent months and fixed asset investment has continued to trend down – most notably in manufacturing and real estate.
- Global steel production has continued to increase – rising by 3.4% yoy over the first nine months. Growth remains driven by China, which produced around half the global total.
- The growth in China's apparent consumption of steel has slowed considerably over 2014, with weaker construction activity a key contributor to this trend. Construction accounted for around 56% of China's steel consumption in 2013.
- Iron ore markets were mixed in October. From mid-month, prices began to rally, pulling away from five year lows recorded in September, before retreating back to these lows at the end of the month. We expect our hybrid spot & contract price to fall to US$93 a tonne at the end of 2014 and further to US$85 by the end of 2015.
- Metallurgical coal spot prices have continued to track sideways across most of October – a trend that had been evident since mid June – before drifting slightly lower, down to around US$111 at the end of the month. We continue to expect prices to trend back towards US$150 a tonne (for hard coking coal) by the end of 2015.
- Spot prices for thermal coal have continued to decline across October – drifting below US$65 a tonne late in the month (at the port of Newcastle) – the lowest spot price in over five years. Our forecast for contract prices remains unchanged, with prices at US$80 a tonne for the 2015 Japanese financial year (commencing April 2015).

Economic overview

- Conditions in China remain the most critical influence on bulk commodity markets – reflecting the sheer scale of China's consumption of these resources. In 2013, Chinese imports accounted for around two-thirds of iron ore trade and around a quarter of thermal and metallurgical coal (having been a net exporter of coal as recently as 2008).

- China's third quarter National Accounts showed the economy grew by 7.3% yoy in the September quarter – the slowest rate of growth since March 2009 (the low point of the GFC). This result needs to be viewed in context – last year's mini-stimulus program distorted activity in Q3 2013 – meaning that sustaining the growth momentum from early 2014 was always unlikely.

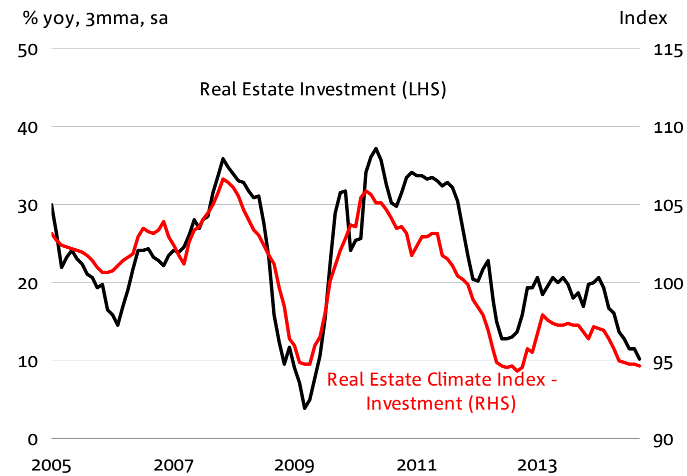
- From a bulk commodity perspective, key parts of China's economy remain comparatively weak. Industrial production has slowed in recent months (with August's growth rate the weakest in over five years) and fixed asset investment has continued to trend down – most notably in manufacturing and real estate.

- We continue to expect China's economic growth to ease, from 7.3% in 2014 to 7.0% in 2015.

- Global economic growth was around 3% yoy in the first half of 2014 – weaker than late 2013 – a level that is sub-trend and with marked variations between major economies. North America has recorded solid growth, in sharp contrast to the faltering recoveries in both Japan and the Eurozone. Conditions are also mixed across emerging market economies. There has been an upturn in India's economy, while trends in Latin American and East Asian economies have been weak – the latter closely tied to trends in world trade.

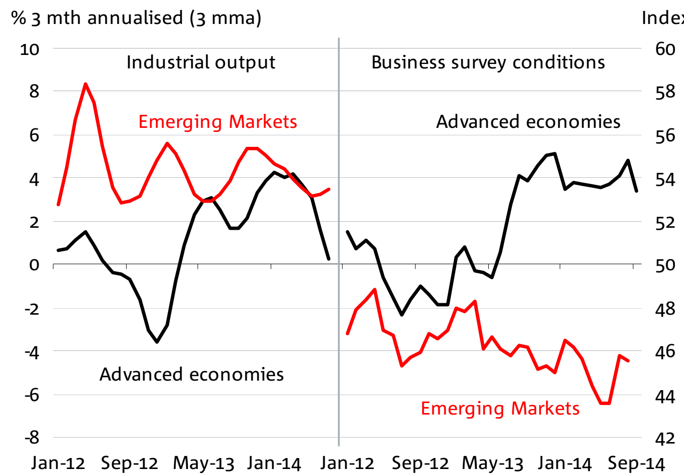
- Global growth is expected to improve in 2015, albeit to a still sub-trend 3.4%, driven largely by the US and India.

China's real estate investment has continued to slow – the sector is a key steel consumer



Source: CEIC, NAB Economics

Mixed trends across global economy – North America stronger, but most others have weakened in 2014

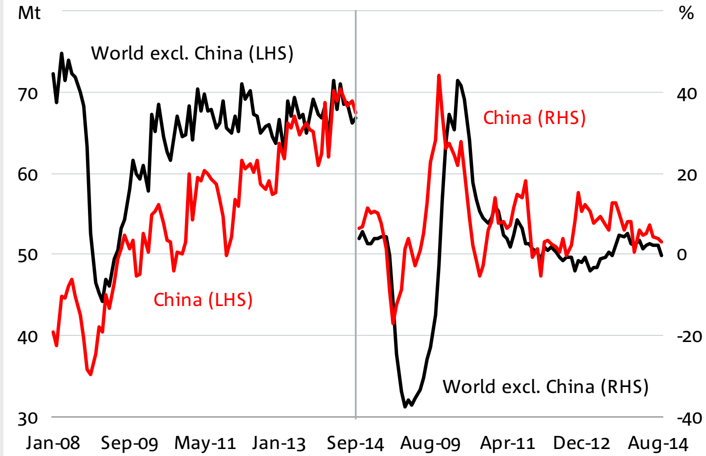


Source: CPB, Datastream, NAB Economics

Global steel industry

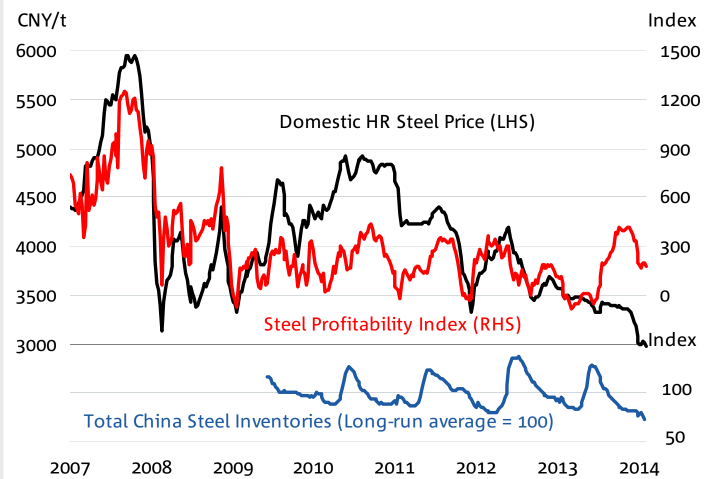
- In the first nine months of 2014, global steel production totalled 1.2 billion tonnes, a year on year increase of 3.4%.
- Growth in global steel production remains driven by China. Over the first nine months of the year, China produced 614 million tonnes of steel – around half of the global total – an increase of 4.8% yoy.
- This growth has come despite attempts to address the key challenges in the sector, including excess capacity, financial constraints and managing air pollution.
- Growth in production outside of China has been comparatively soft – increasing by around 2.1% yoy over the first nine months of the year. The main contributors to the growth over this period were South Korea, India, Russia and the United States. Combined with China, these five producers accounted for almost 90% of the total growth.
- Profitability in China's steel sector has deteriorated slightly in recent weeks – largely reflecting a sharp pullback in domestic steel prices, down below RMB 3000 a tonne, the lowest level since January 2006.
- That said, the profitability index remains comparatively strong, above the average levels over the past five years. This largely reflects weaker prices for raw inputs – iron ore, metallurgical coal and steel scrap.
- Profits for large steel makers have continued to improve. For the first eight months of the year, China Iron and Steel Association (CISA) members recorded total profits of RMB 19.3 billion (compared with RMB 11.3 billion over the same period last year).

China remains the key driver of steel production growth – accounting for over half of global output



Source: World Steel, NAB Economics

Steel prices have fallen in China, but profitability still comparatively strong

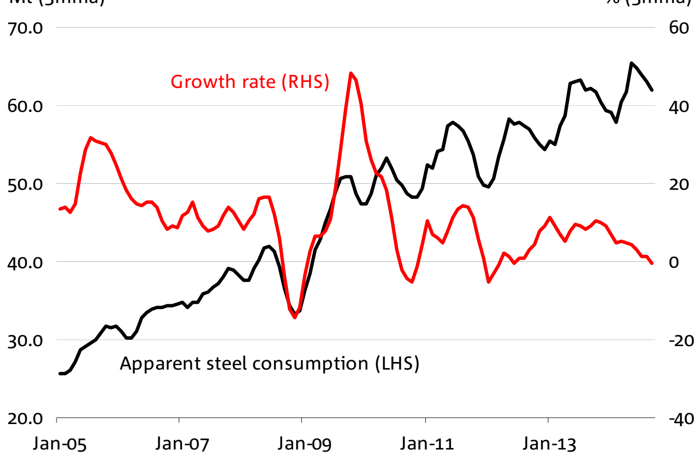


Sources: Bloomberg, NAB Economics

Global steel industry (cont'd)

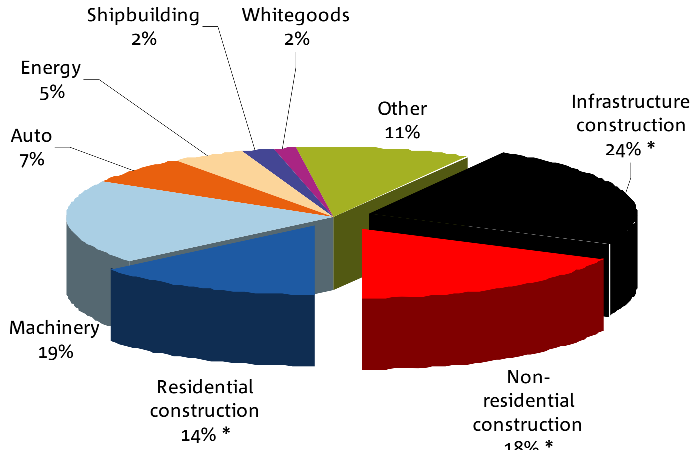
- Data quality remains an issue regarding China's steel consumption. According to the China Iron & Steel Association (CISA), steel consumption over the first eight months of the year totalled 500 million tonnes, a decrease of 0.3% year-on-year.
- In contrast, apparent steel consumption – an estimate based on production, trade and movements in steel stockpiles – indicates that consumption has risen in 2014, albeit the rate of growth has slowed. Over the first eight months, our estimate of apparent consumption was identical to the CISA at 500 million tonnes, but this represents growth of almost 3.0%.
- That said, growth in apparent steel consumption has slowed considerably across 2014 – with the three month moving average rate down to -0.4% yoy in September (from a recent cycle peak of 10.3% yoy in October 2013).
- Weaker construction activity is a key contributor to the slowing trend in apparent steel consumption. In the first nine months of the year, construction starts of commodity buildings – those available for sale in the market, as opposed to social housing – totalled 1.3 billion square metres – down almost 9.3% from the same period last year.
- Construction is a key consumer of steel – with estimates for 2013 suggesting the broad sector accounted for almost 56% of total consumption (MIPRI, OECD).
- Should demand from construction continue to ease, opportunities to export steel may be limited. According to CISA, the cancellation of tax rebates for exporters will impact on producer profitability. The policy change is in part related to reducing excess capacity and pollution concerns.

China's apparent steel consumption has continued to grow in 2014, albeit the rate is slowing



Sources: CEIC, Bloomberg, NAB Economics

Construction accounts for a significant share of China's steel consumption



* Construction breakup based on 2010 estimate
Source: MIPRI, OECD, KPMG, NAB Economics

Iron ore

- Iron ore markets were mixed in October. From mid-month, prices began to rally, pulling away from five year lows recorded in September. Spot prices at the port of Tianjin briefly exceeded US$83 a tonne, before retreating back below US$80 by the end of the month. Short term shutdowns in Hebei – aimed at reducing Beijing pollution during the upcoming APEC meeting – may have influenced this trend.

- The growth rate for China's iron ore imports has slowed in recent months. Over the first nine months of the year, China's imports of iron ore totalled 699 million tonnes, an increase of 16% yoy. This rate of growth has fallen across the year, with a year-on-year increase of just 12% for the three months ending September.

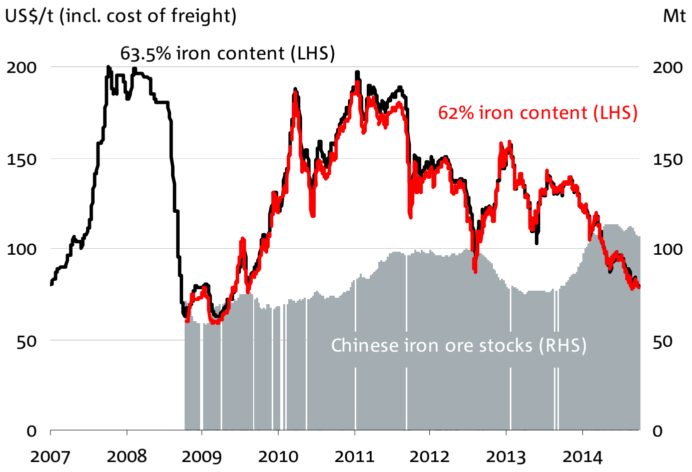
- Iron ore stocks at China's ports remain at high levels, albeit they have trended down in October – down to 107 million tonnes at the end of the month, compared with an all time high of 114 million tonnes in early July.

- Despite falling prices, there has been limited supply response from higher cost Chinese iron ore mines. According to MySteel Research, around 80% of Chinese iron ore mines have cash costs between US$80 and US$90 a tonne. An October BHP Billiton investor presentation noted that private producers have cut around 50 million tonnes of annual capacity, while state-owned operators continue to operate close to full capacity.

- China's domestic iron ore production was at record levels in June – at 139 million tonnes in the month – and it has only marginally eased since then, to around 137 million tonnes in August. That said, the average indicative grade of China's iron ore has fallen from around 13.2% in 2013 to 9.2% in the first nine months of 2014.

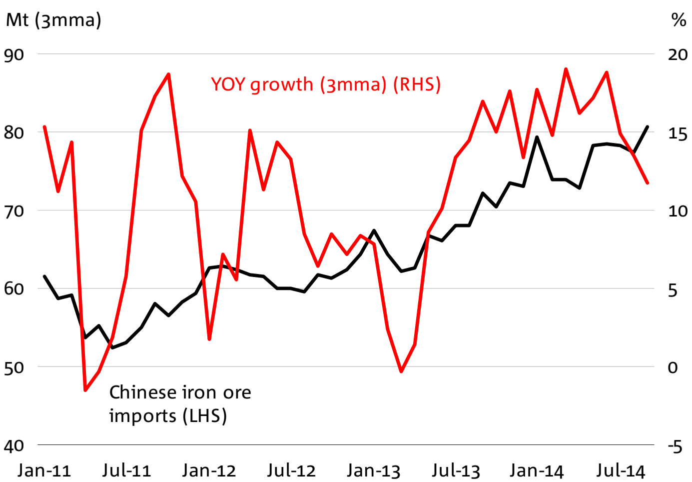
- Planned investment in BHP Billiton's Western Australian operations could reduce cash costs by around 25%, to under US$20 a tonne while raising capacity by 65 million tonnes a year (to 290 million tonnes) by 2017.

After a modest rally in mid-October, spot iron ore prices fell back below US$80 a tonne by month end



Source: Bloomberg, Thomson Datastream, NAB Economics

Growth rate for China's iron ore imports has started to slow



Source: CEIC, NAB Economics

Metallurgical coal

- Metallurgical coal spot prices continued to track sideways across most of October – a trend that had been evident since mid June – before drifting slightly lower, down to around US$111 at the end of the month. Since June, spot prices have been range bound, trading within a band of around US$4 a tonne. Cuts to production since the second quarter of 2014 appear to have stabilised the market.

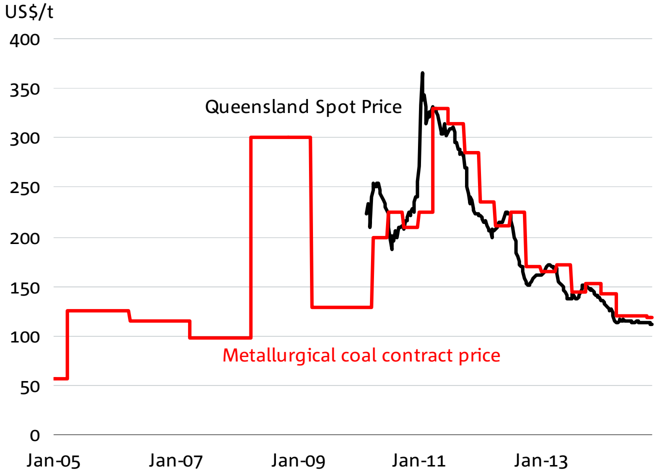
- Contract prices for metallurgical coal for the fourth quarter were settled in late September at US$119 a tonne (down from US$120 a tonne in both Q2 and Q3). This level was surprisingly strong (spot price trends indicated a contract settlement at US$113), possibly indicating the effect of production cuts, with key consumers paying a premium to ensure supply.

- Low prices continue to be a problem for producers globally. Cost analysis by Wood Mackenzie suggests that over half of global output is unprofitable at current prices. A considerable share of higher cost capacity has been taken offline – equivalent to around 20 million tonnes a year since the start of April, mostly in North America (Bloomberg). Weak prices will also likely delay a range of new developments in Australia and overseas.

- China's metallurgical coal imports have remained weak. In the first nine months of 2014, imports totalled 44 million tonnes, a decrease of 19% when compared with the same period in 2013. Anecdotal evidence suggests that domestic production of the material has expanded this year, with improved rail capacity boosting supply to key consuming regions.

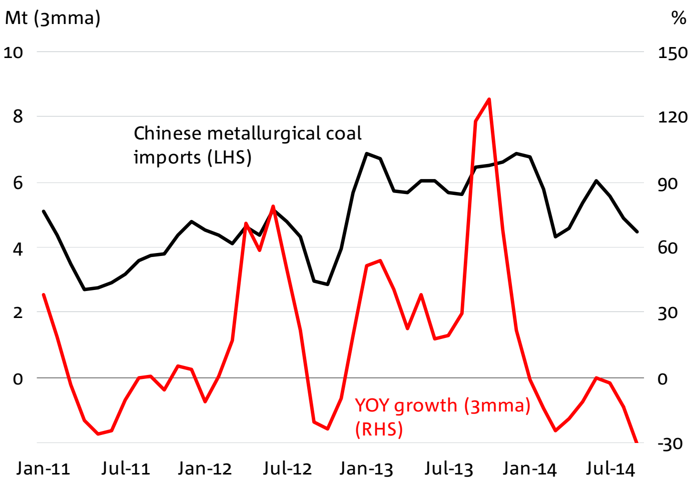
- That said, China's domestic coal industry is also struggling from the current low prices – with the China Coal Association estimating that around 70% of coal miners have made losses this year. The National Development and Reform Commission has called on local governments to cut output by around 12% yoy in the last four months (equivalent to around 150 million tonnes of coal) to address overproduction and illegal mining, in addition to the country's pollution concerns.

Spot prices edged down in late October, but have been relatively stable since June



Source: Energy Publishing, Bloomberg, NAB Economics

China's imports have fallen in year-on-year terms, a major impact on global markets



Source: CEIC, NAB Economics

Thermal coal

- Spot prices for thermal coal have continued to decline across October – drifting below US$65 a tonne late in the month (at the port of Newcastle) – the lowest spot price in over five years. It is likely that there is some seasonal component in this trend – given the lull in demand post the northern summer and ahead of winter purchases.

- That said, recent trends continue to signal a market that is well supplied. Stockpiles at China's major coal ports remain adequate – around typical levels at Qinhuangdao and above the range for Guangzhou. Stocks tend to rise in November ahead of peak winter demand.

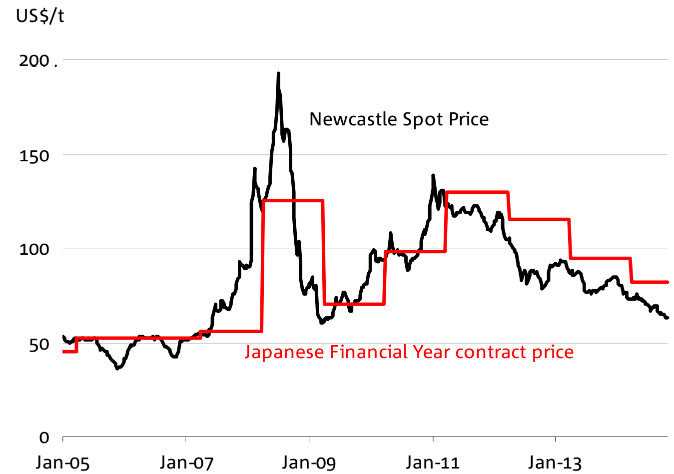
- China's imports of thermal coal have continued to weaken in recent months. In the three months to September, thermal coal imports were around -18% lower than the same period in 2013. In the first nine months of the year, imports were around 2.9% yoy lower.

- China's efforts to address pollution concerns mean that it will restrict production, consumption and import of high ash/high sulphur coal from the start of 2015. Few Australian producers are likely to be significantly impacted by this policy, and Reuters suggest power plants – the country's largest consumers of coal – may be exempt.

- In early October, China's government announced two significant policy measures that could impact on coal demand and trade. The first was the imposition of a tariff on coal imports – 3% for metallurgical coal and 6% for thermal coal. Of concern for Australian exporters is that Indonesian suppliers are exempt – due to an existing free trade agreement with ASEAN.

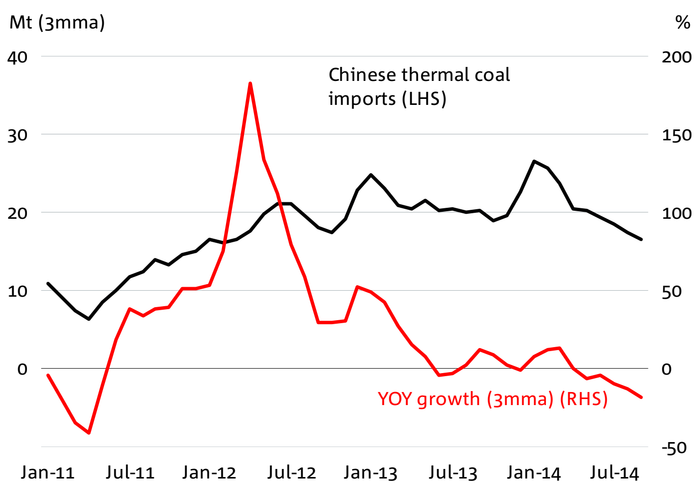
- The second change is the potential introduction of resources taxes for coal miners. The Ministry of Finance announced it will allow provincial governments to impose coal resource taxes of between 2 and 10% - subject to final approval from the Ministry.

Thermal coal prices continue downward trajectory, now at lowest levels in five years



Source: McCloskey's, BREE, NAB Economics

Weaker Chinese imports contributing to a well supplied global market



Source: CEIC, NAB Economics

Australian exports

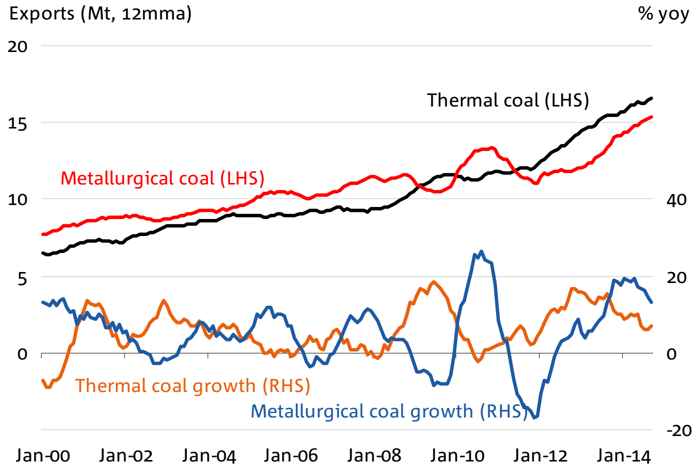
- Major infrastructure developments across the last decade have provided the capacity for large scale increases in the coal and iron ore export volumes. This has particularly been the case for iron ore, where the integrated ownership of mines, rail and port infrastructure allow for well structured capacity growth.

- Despite production cuts globally – in response to weak prices – Australia's exports of metallurgical coal have expanded rapidly in 2014. In the first nine months of the year, exports totalled 137 million tonnes, an increase of 11% from the same period last year.

- Similarly Australian exports of thermal coal have increased significantly in 2014 – rising by 7.6% yoy in the first nine months of the year – to 148 million tonnes. That said, the rate of growth of thermal coal has slowed in recent months, as producers have attempted to address oversupply.

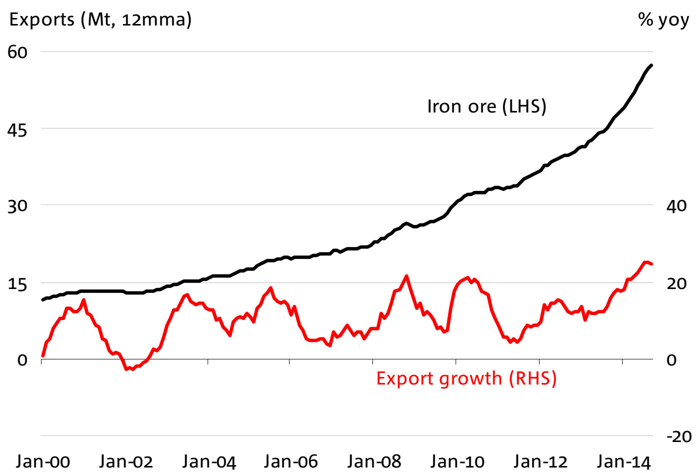
- The growth in Australia's iron ore exports have been a key contributor to the relative weakness in spot iron ore markets in 2014. In the first nine months of the year, Australian iron ore exports totalled 528 million tonnes, a year-on-year increase of 26%. Over this period, almost 80% of these exports were delivered to China.

Growth in metallurgical coal exports has outpaced thermal in 2014



Sources: Bloomberg, NAB Economics

Iron ore export growth has accelerated as new capacity has come on line



Sources: Bloomberg, NAB Economics

Price outlook

- The sustained weakness in spot prices for thermal coal (steeply discounted to current contracts) highlights the downside risk to our current contract price forecast. However, stronger seasonal demand (related to purchases ahead of the northern winter), the impact of China's tariff and resources tax policies and production cuts could drive prices marginally higher in the short term. Our forecast for contract prices remains unchanged, with prices at US$80 a tonne for the 2015 Japanese financial year (commencing April 2015).

- The poor profitability conditions for metallurgical coal producers and a recovery in Chinese import purchases should allow prices to trend back from current lows. We continue to expect prices to trend back towards US$150 a tonne (for hard coking coal) by the end of 2015.

- Iron ore prices remain weak, and our hybrid iron ore price (which weights spot and contract prices) is expected to decline further – reflecting the growth of supply. We expect prices to fall to US$93 a tonne at the end of 2014 and further to US$85 by the end of 2015 (with current spot prices highlighting downside risk).

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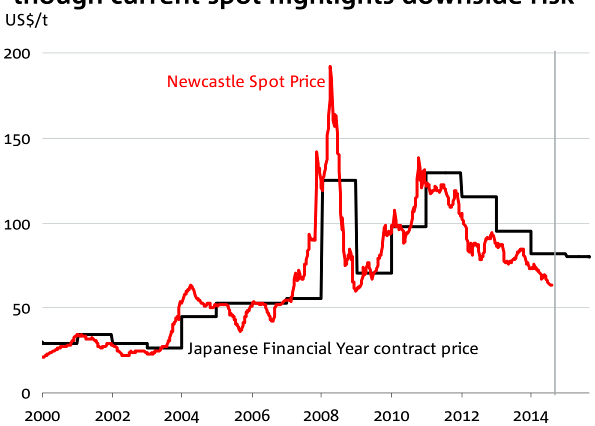
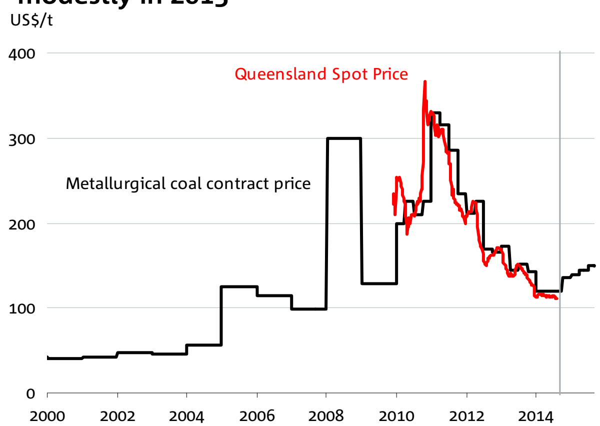
Thermal coal contract expected to ease slightly though current spot highlights downside risk



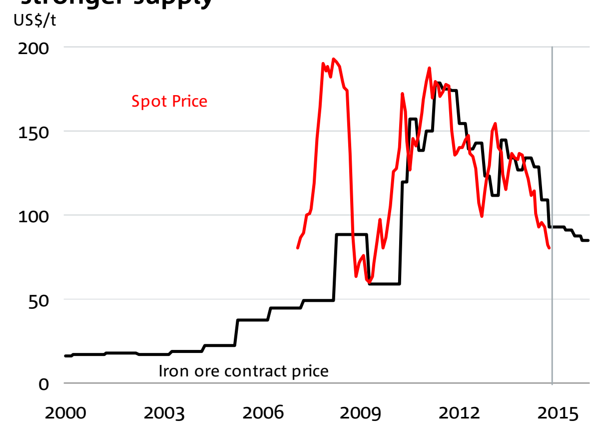
Sources: BREE, Bloomberg, NAB Economics

Metallurgical coal prices expected to recover modestly in 2015



Sources: BREE, Bloomberg, Energy Publishing, NAB Economics

Iron ore prices to trend lower in 2015 on stronger supply



Source: BREE, Bloomberg, NAB Economics

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